218 file (2) sources

Hungary's Proposals for Decentralizing Its Banking System and Creating The First "Socialist" Capital Market

Introduction

Hungary this year is initiating the first major modernization of economic reforms that caught international attention nearly two decades ago. Budapest is attempting to move its "New Economic Mechanism" of 1968 into the late 1980s through measures that further displace Stalinist central planning in favor of elements of a competitive market economy. Among the most innovative and controversial new reforms are those calling for decentralization of the banking system and establishment of a Western-like stock exchange for trading negotiable bonds and ownership shares of state enterprises. These measures, in the parlance of Hungarian reformers, constitute improved "financial intermediation"--the creation of new types of financial institutions and legal documents that promote a transfer of assests from less to more productive activities, relatively unencumbered by central planners. [redacted] 25X1

Improved financial intermediation, according to many Hungarian advisors, requires interrelated reforms in three areas:

-- replacing the monopoly over central and commercial banking exercised by the National Bank of Hungary (NBH) with a "two-tiered" system in which (a) the NBH remains as the central bank and (b) a separate network is set

EUR M 85-10009

[redacted] 25X1

up consisting of numerous small banks that are profit-oriented and in some respects in competition with each other and the NBH in attracting savings and extending credit;

-- introducing new financial instruments, such as bonds and equity shares, that (a) promote voluntary saving by state and collective enterprises as well as the general public and (b) facilitate the flow of surplus funds to enterprises with potential profitmaking opportunities; and

-- establishing a quasi-autonomous market that "discounts" bonds and share capital in a fashion that resembles "stock exchanges" of the West. [redacted] 25X1

The following describes the measures that Budapest has taken or plans to introduce to reform the financial system followed by a list of questions about these reforms and their expected impact on the economy.

<u>Decentralizing the Banking System</u>

According to many Hungarian reformers, a key priority in modernizing Hungary's "system of economic management" is to reorganize banking institutions and procedures. Proposals range from a simple reorganization that separates central from commercial banking functions within the central bank (NBH) to making commercial banking operations organizationally independent of the NBH. In the latter case, commercial banks would compete for business in both their loan and deposit operations; they would become "entrepreneurial" advisors, creditors, and business partners of enterprises--not just agents of the government checking on a firm's compmliance with central priorities. Since 1980, numerous small financial institutions have been created with a more profit-oriented focus than the NBH and its central affiliates. These constitute initial steps toward creating an institutional framework for the kind of financial intermediation Hungarian reformers advocate. 25X1

A government decree in 1980 authorized the organization of small financial intermediaries that offer venture capital. Since then, more than a dozen have been created to provide financial backing to (a) promising inventions and innovations, (b) the new small private, cooperative, and state business ventures, and (c) export development and marketing projects. These venture-capital institutions provide loans that the borrower must service or equity shares in exchange for a contractually agreed upon annuity or dividend-type profit sharing arrangement. They are simultaneously financial intermediaries and investment associations that take risks. Since pursuing innovations, setting up new business ventures, and developing new markets involve risks, these institutions fill a need for venture capital that Hungary's Soviet-like financial institutions are not well suited to provide. 25X1

Several "mutual development funds" are also in operation and chiefly offer funds for investment in innovation and technical development projects. Several of the funds were established jointly by the State Technical Development Commission (STDC) and the respective branch ministries; others were set up by national associations of industrial, agricultural, and service cooperatives; still others were subordinated to local government units for the benefit of enterprises under their jurisdiction. These funds resemble financial intermediaries because they collect capital from some of the enterprises and cooperatives they support. They are not really financial intermediaries, however, because they generally offer only nonrepayable grants rather than loans or equity financing. 25X1

Introducing New Financial Instruments

Bonds. A government decree effective 1 January 1983 gave enterprises, cooperatives, financial institutions, and local governments the right to issue and purchase bonds. The main stipulations are that the issuer must state for whom the bonds are intended and the bonds must be issued through a bank. If the bonds are to be purchased by the general public, they must be guaranteed by the state, which sets the maximum rate of interest; if intended to be purchased only by other enterprises, they are neither guaranteed nor regulated. 25X1

Bonds represent new instruments for facilitating financial intermediation. They are intended to increase enterprise profits and personal income incentives, to mobilize voluntary savings by enterprises and the public, and aid in solving problems in production and services. Financial intermediation of this kind should help reallocate capital from less to more productive users, for which no effective mechanism exists in a traditional centrally planned economy. 25X1

Equity Shares Creating a market for ownership captial would make two key contributions to improving the efficiency of Hungary's economic system. First, it could help solve the problem of realistically valuing enterprise assets on the basis of their current and expected rate of return (and the caliber of top management would be a factor in the assessment). Second, it could provide an important new mechanism for allocating capital from less to more productive uses in the following ways:

-- corporations would be required to pay dividends to the holders of their shares, which, in turn could be ploughed back or invested elsewhere;

-- new corporations could be established by issuing shares; existing corporations could expand by marketing additional shares;

-- changes in share values would help guide banks, other creditors, and investors in their decisions.

-- If shares could become an investment vehicle for corporations, cooperatives, and possibly the general public, (bank-managed mutual funds might be an ideologically acceptable vehicle), this would help mobilize risk capital and thus increase the economy's total savings. 25X1

Creating a Capital Market

The main features of the capital market that Hungarian reformers hope to but in place include the following:

-- State enterprises would be transformed into corporations. The par value of their shares would equal the book value of their assests. A market would be created to establish, on a continuing basis, the value of the shares, reflecting the current and prospective rate of return on the corporation's assets.

-- In some proposals only holding companies created for that purpose would be allowed to own and trade shares; others would also allow banks, insurance companies, the social security fund, trade unions, and other public organizations to participate, still others would not rule out enterprise and possibly individual participation, although it is not envisaged that individuals would become more than marginal investors (i.e., owners).

-- The main market creators would be competing holding companies, each run by a board of directors comprised of persons appointed by the government and representatives of the controlled companies. The chief goal of the board would be to maximize the holding company's assets; its management would be given an attactive incentive package to achieve the best possible financial results. [redacted] 25X1

Of the various proposals for improving financial intermediation, the creation of something like a stock exchange

Sanitized Copy Approved for Release 2009/11/02 : CIA-RDP85T01058R000202180002-2

seems the most daring. Since stock markets are universally viewed as purely capitalist institutions the Western press almost certainly would hail such a development as a "return to capitalism," creating ideological difficulties with Hungary's much more conservative CEMA partners. [redacted] 25X1

Sanitized Copy Approved for Release 2009/11/02 : CIA-RDP85T01058R000202180002-2

ATTACHMENT: QUESTIONS ON BANKING REFORMS

1. We understand that this year Hungary is launching a "new phase" in reforming its system of economic management. How does reorganization of the banking system fit into this process and how is banking expected to improve efficiency in the economy?

2. We gather that a consensus has been reached on the need to separate the central and commercial banking functions of the National Bank of Hungary. Will this be done simply by separating certain departments within the bank headquarters or, as some have suggested, by setting up a separate network of commercial banks independent of the National Bank? When are these changes likely to take place?

3. If commercial banks are separated from the central bank, how will the latter control the former? What macroeconomic instruments of monetary control do the Hungarians plan to use? How would the fixing of interest rates and foreign exchange rates be handled?

4. How far along is the government in developing a new bankruptcy law? What role will the National Bank play in liquidating enterprises, handling their debts, and selling off property?

5. Related to the banking reforms are the recent efforts by state enterprises to sell bonds and equity shares as first steps in the creation of a sort of capital market. Has the bond program been successful? Will it be enlarged significantly in

the near future? Can you offer some examples of firms that have sold ownership shares? How will the trading and discounting of bonds and shares take place? What will be the role of the National Bank in this?

6. How do Hungarians answer charges by Western journalists that they are starting to set up a stock exchange and in other ways "returning to "capitalism"? Is Hungary feeling any outside pressure from its more ideologically conservative allies in CEMA? Are any CEMA countries studying Hungary's banking reforms with a view toward introducing similar changes in their economies?